

VALUATION CONSIDERATIONS FOR HIGH GROWTH COMPANIES

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Armanino specializes in valuations for venture capital-backed, early stage technology companies. We have provided more than 800 valuations for compliance with 409A tax regulations, FAS123R/ASC 718 accounting rule and other tax, accounting and strategic purposes. Under IRC 409A, privately-held companies must establish that stock options are granted at fair market value or above. Noncompliance represents penalties, interest and potential tax liabilities to the employee and the company. Companies planning to issue stock options should consider an independent valuation—no less than once every 12 months or more frequently if there are positive business developments. The 409A rules provide a safe harbor if the valuation is prepared by an independent specialist, and place the burden of proof on the IRS to show that a valuation is grossly unreasonable.

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The Financial Accounting Standards Board Statement No. 123R (FAS 123R) now Accounting Standards Codification 718 (ASC 718) mandates that affected companies must expense stock options and other forms of equity based employee compensation. A determination of the “fair value” of the company's stock is required as the basis of valuing the options. While there are differences between “fair market value” from a tax perspective and “fair value” from an accounting perspective, in many cases the differences in definitions and acceptable valuation methods are relatively minor. Many companies seek to use the same valuation report for compliance with both 409A and FAS 123R/ASC 718 requirements. The AICPA has issued a practice aid that describes “best practices” for valuations of privately-held companies. It is generally believed that valuations prepared in accordance with the AICPA practice aid will satisfy 409A requirements, although this has not been confirmed by the IRS.

Overview of the Process

The basic outline of the valuation process is straight forward. The valuation specialist provides a data request, receives the requested data, and interviews management. The specialist prepares a quantitative and qualitative analysis, and prepares a written report.

The specialist considers the company's current state of development and the strength and reliability of available information. One or more of the generally accepted valuation methodologies is selected (the Cost Approach, the Income Approach, and/or the Market Approach). If the company has multiple classes of equity (i.e. common and preferred), one of three allocation methods must be selected to allocate the value among its different equity classes. The Options Pricing Method is most frequently used. The use of the Current Method is limited by the AICPA practice aid guidelines. The

Probability Weighted Expected Return Method is acceptable but can be complex and requires extensive assumptions and substantiation.

Discounts play an important role in valuation and the analyst must take special care in the use and determination of discounts. The key ones are the weighted average cost of capital (WACC) used to discount future cash flows to their present values; the marketability discount reflecting the difference in value between the “illiquid” stock of a privately held company and an equivalent stock of a public company; and the minority discount which reflects the difference between control and non-control positions.

Special Challenges

It has sometimes been said that the area of valuation best applies to companies that are large, established, and growing at stable rates and in predictable ways. Valuation often relies on historical performance and patterns as indicators of a company’s future financial performance. Unfortunately, this describes few early stage technology companies. These companies have a host of challenges that must be addressed by the valuation analyst, including:

- **Stage of development** — The stage of development of the company must be carefully considered and affects many aspects of the valuation. For instance, the marketability discount and the WACC are based on an assessment of the company’s stage of development, usually with reference to whether or not a company is “pre-revenue” or in an “early revenue” phase. While a company may have some revenues, it may still be in an early revenue or pre-commercialization stage of development relative to its business model. This can happen if the company has received research grants, or when initial revenues are for engineering and consulting services or for relatively small volumes of the product that have been purchased for evaluation purposes.
- **Few comparable public companies** — Technology companies typically pursue strategies and business models that are highly innovative and differentiated when the subject company is compared to a set of public or acquired companies that are different in terms of business models, stage of development, size, growth rates and profitability. The valuation specialist needs to examine the levels of value observed in the market place and make a judgment concerning the relative placement of the subject company. Market values of public companies can be volatile. In early 2008, for instance, the market values of many of the public technology firms declined substantially.

- Speculative financial projections — Early stage companies are typically in the process of discovery and may have developed unique technical capabilities and product concepts that become commercially viable. They have not yet encountered all the challenges and impediments to success that they will ultimately face. As a result, they may not have reliable forecasts of revenue or complete financial forecasts. The valuation specialist needs to discern what aspects are reliable about the projections (e.g., near term revenues and costs) and make a judgment concerning how they are used in the analysis.
- Complex capital structures — Technology companies frequently have several classes of preferred equity with a variety of rights and privileges. Preferred equity may be participating or non-participating, or subject to participation caps. There may be debt and warrants, and/or there may be dividend rights on the preferred, or special “carve-outs” of the proceeds from the sale of the company (e.g., a management bonus pool). The value of the common shares is impacted by the rights and privileges claimed by preferred shares and other forms of capital.

These challenges and others can be potential pitfalls in the valuation of a high-tech company. Successful development and acceptance of the valuation analysis requires careful consideration of the views of management and the company’s auditors. The valuation specialist must have an understanding of traditional valuation practices, but must also be familiar with the AICPA practice aid. More fundamentally, the valuation specialist must be able to apply these rules to the company’s specific stage of development, capital structure and market dynamics.

About Armanino^{LLP}

Armanino provides an integrated set of accounting services—audit, tax, consulting and technology solutions—to a wide range of organizations operating both in the US and globally. You can count on Armanino to think strategically, to provide the sound insights that lead to positive action. We address not just your compliance issues, but your underlying business challenges, as well—assessing opportunities, weighing risks, and exploring the practical implications of both your short- and long-term decisions. When you work with us, we give you options that are fully aligned with your business strategy. If you need to do more with less, we will implement the technology to automate your business processes. If it's financial, we can show you proven benchmarks and best practices that can add value company-wide. If the issue is operational, we'll consult with your people about workflow efficiencies. If it's compliance, we'll ensure you meet the requirements and proactively plan to take full advantage of the changes at hand. At every stage in your company's lifecycle, we'll help you find the right balance of people, processes, and technology.

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